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Protectionism

The fact that trade protection hurts the economy of the country that imposes it is one of the oldest but still most startling insights economics has to offer. The idea dates back to the origin of economic science itself. Adam Smith's *The Wealth of Nations,* which gave birth to economics, already contained the argument for free trade: by specializing in production instead of producing everything, each nation would profit from free trade. In international economics, it is the direct counterpart to the proposition that people within a national economy will all be better off if they specialize at what they do best instead of trying to be self-sufficient.

It is important to distinguish between the case for free trade for oneself and the case for free trade for all. The former is an argument for free trade to improve one nation's own welfare (the so-called "national-efficiency" argument). The latter is an argument for free trade to improve every trading country's welfare (the so-called "cosmopolitan-efficiency" argument).

Underlying both cases is the assumption that free markets determine prices and that there are no market failures. But market failures can occur. A market failure arises, for example, when polluters do not have to pay for the pollution they produce. (See EXTERNALITIES.) But such market failures or “distortions” can arise from governmental action as well. Thus, governments may distort market prices by, for example, subsidizing production, as European governments have done in aerospace, as many other governments have done in electronics and steel, and as all wealthy countries’ governments do in agriculture. Or governments may protect intellectual property inadequately, leading to underproduction of new knowledge; they may also overprotect it. In such cases, production and trade, guided by distorted prices, will not be efficient.

The cosmopolitan-efficiency case for free trade is relevant to issues such as the design of international trade regimes. For example, the General Agreement on Tariffs and Trade (GATT), incorporated into the World Trade Organization in 1995, oversees world trade among member nations, just as the International Monetary Fund oversees international macroeconomics and exchange rates. The national-efficiency case for free trade concerns national trade policies; it is, in fact, Adam Smith's case for free trade. Economists typically have the national-efficiency case in mind when they discuss the advantage of free trade and the folly of protectionism.

This case, as refined greatly by economists in the postwar period, admits two main theoretical possibilities in which protection could improve a nation's economic well-being. First, as Adam Smith himself noted, a country might be able to use the threat of protection to get other countries to reduce their protection against its exports. Thus, threatened protection could be a tool to pry open foreign markets, like oysters, with "a strong clasp knife," as Lord Randolph Churchill put it in the late nineteenth century. If the protectionist threat worked, then the country using it would gain doubly: from its own free trade and from its trading partners' free trade. However, both Smith and later economists in Britain feared that such threats would not work. They feared that the protection imposed as a threat would be permanent and that the threat would not lower the other countries' trade barriers.

The United States’ trade policy today is premised on a different assessment: that, indeed, U.S. markets can, and should, be closed as a means of opening new markets abroad. This premise underlies sections 301 through 310 of the 1988 Omnibus Trade and Competitiveness Act. These provisions permit, and sometimes even require, the U.S. government to force other countries into accepting new trade obligations by threatening tariff retaliation if they do not. But those "trade obligations" do not always entail freer trade. They can, for instance, take the form of voluntary quotas on exports of certain goods to the United States. Thus, they may simply force weak nations to redirect their trade in ways that strong nations desire, cutting away at the principle that trade should be guided by market prices.

The second exception in which protection could improve a nation's economic well-being is when a country has monopoly power over a good. Since the time of Robert Torrens and John Stuart Mill—that is, since the mid-1800s—economists have argued that a country that produces a large percentage of the world's output of a good can use an "optimum" tariff to take advantage of its latent monopoly power and, thus, gain more from trade. This is, of course, the same as saying that a monopolist will maximize his profits by raising his price and reducing his output.

Two objections to this second argument immediately come to mind. First, with rare exceptions, such as OPEC (see OPEC), few countries seem to have significant monopoly power in enough goods to make this an important, practical exception to the rule of free trade. Second, other countries might retaliate against the optimum tariff. Therefore, the likelihood of successful (i.e., welfare-increasing) exploitation of monopoly power becomes quite dubious. Several economists, among them Avinash Dixit, Gene Grossman and Paul Krugman, made their academic reputations by finding theoretical cases in which oligopolistic markets enable governments to use import tariffs to improve national welfare, but even these researchers have advised strongly against protectionist policies. Their advice is based principally on the fact that governments would rarely have the necessary information to know where to apply the tariffs.

One may well think that any market failure could be a reason for protection. Indeed, economists fell into this trap for nearly two centuries, until the 1950s. Economists now argue, instead, that protection would be an inappropriate way to correct for domestic market failures. For example, if wages do not adjust quickly enough when demand for an industry's product falls, as was the case with U.S. autoworkers losing out to foreign competition, the appropriate policy is for the government to intervene, or possibly to remove intervention, in the labor market, directly aiming remedial policy at the source of the problem. Protection would be, at best, an inefficient way of correcting for the market failure. This is the principal insight from the post World War II theory of commercial policy: it significantly narrows the rationale for protectionism and has revolutionized the conventional understanding of the relative merits of free trade and protectionis.

Many economists also believe that even if protection were appropriate in theory, it would, in practice, be "captured" by groups who would misuse it to pursue their own narrow interests instead of the national interest. One clear cost of protection is that the country imposing it forces its consumers to forgo cheap imports. But another important cost of protection may well be the lobbying costs incurred by those seeking protection. These lobbying activities, now extensively studied by economists, are variously described as rent-seeking or directly unproductive profit-seeking activities. They are unproductive because they produce profit or income for those who lobby, without creating valuable output for the rest of society.

Protectionism arises in ingenious ways. As free trade advocates squelch it in one place, it pops up in another. Protectionists seem to always be one step ahead of free traders in creating new ways to protect against foreign competitors. One way is by replacing restrictions on imports with what are euphemistically called "voluntary" export restrictions (VERs) or "orderly" market arrangements (OMAs). Instead of the importing country restricting imports with quotas or tariffs, the exporting country restricts exports. The protectionist effect is still the same. The real difference, which makes exporting nations prefer restrictions on exports to restrictions on imports, is that the VERs enable the exporters to charge higher prices and, thus, collect for themselves the higher prices caused by protection.

That has been the case with Japan's voluntary quotas on exports of cars to the United States. The United States could have kept Japanese car imports in check by slapping a tariff on them. That would have raised the price, so that consumers would have bought fewer. Instead, the Japanese government limited the number of cars shipped to the United States. Since supply was lower than it would have been in the absence of the quotas, Japanese car makers were able to charge higher prices and still sell all their exports to the United States. The accrual of the resulting extra profits from the voluntary export restraint may also, ironically, have helped the Japanese auto producers find the funds to make investments that made them yet more competitive.

The growth of VERs in the 1980s was a disturbing development for a second reason as well. They selectively target suppliers instead of letting the market decide who will lose when trade must be restricted. As an alternative, the United States could provide just as much protection for domestic automakers by putting a quota or tariff on all foreign cars, letting consumers decide whether they wanted to buy fewer

Japanese cars or fewer European ones. With VERs, in other words, politics replaces economic efficiency as the criterion determining who trades what.

Protectionism recently has come in another, more insidious form than VERs. Economists call the new form "administered protection." Nearly all rich countries today have what are called "fair trade" laws. The stated purpose of these laws is twofold: to ensure that foreign nations do not subsidize exports (which would distort market incentives and hence destroy efficient allocation of activity among the world's nations) and to guarantee that foreign firms do not dump their exports in a predatory fashion. National governments, therefore, provide for procedures under which, when subsidization or dumping is found to occur, a countervailing duty (CVD) against foreign subsidy or an antidumping (AD) duty can be levied. These two "fair trade" mechanisms are meant to complement free trade.

In practice, however, when protectionist pressures rise, "fair trade" is misused to work against free trade. Thus, CVD and AD actions often are started against successful foreign firms simply to harass them and coerce them into accepting VERs. Practices which are thoroughly normal at home are proscribed as predatory when foreign firms engage in them. As one trade analyst put it, "If the same anti-dumping laws applied to U.S. companies, every after-Christmas sale in the country would be banned."

Much economic analysis shows that, in the 1980s, "fair trade" mechanisms turned increasingly into protectionist instruments used unfairly against foreign competition. U.S. rice producers got a countervailing duty imposed on rice from Thailand, for example, by establishing that the Thai government was subsidizing rice exports by less than one percent—and ignoring the fact that Thailand also slapped a five-percent tax on exports. We usually think that a foreign firm is dumping when it sells at a lower price in our market than in its own. But the U.S. government took an antidumping action against Poland's exports of golf carts, even though no golf carts were sold in Poland.

Therefore, economists have thought increasingly about how these "fair trade" mechanisms can be redesigned so as to insulate them from being "captured" and misused by special interests. Ideas include the creation of binational, as opposed to purely national, adjudication procedures that would ensure greater impartiality, as in the U.S.-Canada Free Trade Agreement, then incorporated into the enlarged NAFTA with Mexico. Also, greater use of WTO dispute-settlement procedures, and readier acceptance of their outcomes, is a possibility.

Increasingly, domestic producers have labeled as "unfair trade" a variety of foreign policies and institutions. Thus, opponents of the U.S.-Mexico Free Trade Agreement claimed that free trade between the two nations could not be undertaken because of differences in Mexico's environmental and labor standards. The litany of objections to gainful, free trade from these alleged sources of "unfair trade" (or its evocative synonym, "the absence of level playing fields") is endless. Here lies a new and powerful source of attack on the principles of free trade.

The current concerns about protectionism extend to two main issues. First, the exclusion of rich-country agricultural protectionism, chiefly in the form of production and trade subsidies exempted from GATT-discipline by a waiver in 1965, is finally being challenged effectively. This is good for universal free trade. Second, economic analysts have been profoundly concerned by the proliferation of bilateral free trade agreements, now known as Preferential Trade Agreements (PTAs), which currently are almost 300. Thanks to these PTAs and the massive extension of Special & Differential treatment to the poor countries, under which they get varying exemptions from the Most Favored Nation (MFN) tariff (see INTERNATIONAL TRADE AGREEMENTS), there has now been a serious, systemic erosion of the MFN principle, which assured that every trading nation that was party to GATT would enjoy the most-favored nation, that is, the lowest, tariff that others enjoyed. This is bad for universal free trade.

About the Author

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